July 10, 1998

The Honorable Edward J. Markey
U.S. House of Representatives
2133 Rayburn House Office Building
Washington, D.C. 20515-2107

Dear Congressman Markey:

Thank you for your letter of June 11, 1998, regarding the privacy of personal financial information. I share your concerns that investors' privacy should not be compromised, and believe that the NASD should take the steps necessary to increase the security of personal financial information. I understand that the NASD is looking into these issues, and I hope they will act in the near future.

I have asked my staff to address your specific questions in the enclosed memorandum. Please do not hesitate to let me know if I can be of further assistance.

Sincerely,
Arthur Levitt

Enclosure

MEMORANDUM

July 8, 1998

TO: Chairman Levitt

FROM: Richard R. Lindsey, Director
Division of Market Regulation

Barry P. Barbash, Director
Division of Investment Management

RE: Questions Regarding Privacy of Personal Financial Information Posed By Congressman Edward J. Markey By Letter Dated June 11, 1998

RESPONSES TO CONGRESSMAN MARKEY'S QUESTIONS

1. Do registered broker-dealers, investment advisers, and investment companies have any obligation to safeguard the personal financial information of their clients?

Registered broker-dealers, investment advisers, and investment companies generally do not have an obligation to safeguard the personal financial information of their clients under the federal securities laws. In a recent interpretive release, however, the Commission has reminded members of the securities industry that they should protect the security of personal financial information that is distributed through electronic media. The Commission stated: "[b]roker-dealers, transfer agents, and investment advisers sending Personal Financial Information should take reasonable precautions to ensure the integrity,

confidentiality, and security of that information, regardless of whether it is delivered through electronic means or in paper form." The Commission defined Personal Financial Information as information "specific to a particular person's personal financial matters."

Contractual arrangements may also serve to protect investors' privacy. For instance, the functions performed by an investment company's investment adviser, administrator, distributor, and transfer agent may give them access to personal financial information relating to the investment company's shareholders. Provisions in the contracts between an investment company and its service providers could prohibit the service providers from using or selling personal financial information regarding the investment company's shareholders.

In addition, in some circumstances securities industry participants have market incentives to effectively protect the security of client data. Protecting clients' personal financial information helps minimize the likelihood that client-specific information could be obtained by a competing firm and used to lure away clients.

2. Are any broker-dealers, investment advisers, or investment companies utilizing the services of the data brokers referred to in the June 11, 1998, *Washington Post* article titled "For Sale on the Web: Your Financial Secrets" to identify potential customers?

Due to the large numbers of registered broker-dealers, investment advisers, and investment companies, it is difficult to say with certainty the extent to which any of these entities uses the services of data brokers referred to in the *Washington Post* article.

After receiving this question, we made a number of inquiries of broker-dealer, investment adviser and investment company communities regarding the use of services provided by data brokers to identify potential customers. To date, we have received limited responses to our inquiries. Representatives of one large financial services complex, however, have indicated to us that its broker-dealer subsidiary, which also serves as the distributor for its mutual funds, does not use the services of any of the data brokers mentioned in the *Washington Post* article to identify prospective customers. In addition, we have been advised by a representative of a securities industry trade association that they have been in contact with three large broker-dealers and that those broker-dealers also indicated they do not use any of the data brokers mentioned in the article.

A recently published article in the *Wall Street Journal* suggests that some investment company advisers may utilize data brokers. The article states that a number of large investment company complexes maintain data "warehouses," which the article describes as centralized data repositories that compile information on customers from shareholder accounts and feed in demographic and market research data. Data brokers may supply certain demographic and market research information to the data warehouses. While we have not independently verified any of the information contained in the article, some members of the investment management industry have indicated informally that the use of data brokers by investment company service providers may not be as widespread as the article suggests. In fact, none of the representatives from the investment management industry that we contacted utilized the services of, or provided information to, data brokers.

We anticipate receiving additional responses to our inquiries in the near future. We will forward relevant information contained in those responses as soon as that information is available.

3. Does the Commission or do the self-regulatory organizations ("SROs") have the authority under the federal securities laws to address the privacy concerns raised by this article?

We believe that the SROs have authority under the federal securities laws to address the privacy concerns raised by the *Washington Post* article to the extent that they relate to the activities of broker-dealers.

As discussed in more detail below in response to question 4, the NASD has proposed a rule that would govern members' use and release of customer confidential financial information. If adopted, the rule would apply to broker-dealers, including investment advisers that are registered broker-dealers. The rule also would apply to those investment company distributors that are required under the Securities Exchange Act of 1934 to be registered broker-dealers.

It is unclear, however, whether the Commission has the authority to address directly the privacy concerns raised by the *Washington Post* article with respect to investment advisers and investment companies that distribute their shares directly to the public without using a broker-dealer distributor. The federal securities laws do not contain an explicit requirement that investment advisers or investment companies keep confidential the personal financial information of clients and shareholders. Although the Commission has general rulemaking authority under the Investment Advisers Act of 1940 and the Investment Company Act of 1940, it is not clear whether that rulemaking authority would permit the Commission to adopt rules addressing the privacy concerns raised by the article.

4. What is the status of the rule proposed by the NASD in 1997 relating to customer privacy?

We understand that the NASD is actively considering proposed Rule 3121, which would place restrictions on the use and release of customer confidential financial information to affiliates and non-affiliates of NASD members. Under the proposed rule, an NASD member would generally be forbidden from releasing confidential financial information to a non-affiliate, unless before releasing the information the member conspicuously disclosed to the customer that the information may be released and that the customer has the right to object to its release. The member would then be obligated to obtain the customer's written consent to the release of such information. Such information could be released to a member's affiliates if the member made the same customer disclosures and the customer had not objected within a meaningful period of time to the release of the information.

The proposed rule defines "confidential financial information" as customer financial information other than lists of customer names, addresses, and telephone numbers, or information that can be obtained from unaffiliated credit bureaus or similar companies in the ordinary course of business. For purposes of the rule, an "affiliate" would include persons and entities with which the member maintains a control relationship or has a contractual arrangement for the purpose of servicing customers. Thus, an entity that maintains a "networking" arrangement with a member firm, but that has no other type of affiliation with it, would be considered an "affiliate."

The NASD has advised us that it is working with its members and securities industry trade associations as it considers comments received on the proposed rule. It also is assessing the potential relevance of the rule to issues that may arise in connection with the upcoming implementation of the EU's data protection regime.

5. Is the Commission concerned that the apparent failure of the SROs to assure adequate privacy protections will make it more likely that the U.S. will be unable to meet the European Union's standards for privacy protection? If so, what would be the impact of such an action on securities transactions involving U.S. and European parties?

The Commission's staff continues to be in contact with EU securities regulators, other federal agencies,

and industry groups regarding the upcoming implementation of the EU data protection regime. At this time, little information is available on what processes and standards are likely to be used by the EU member countries in assessing whether a non-EU country's data protections meet their data protection requirements. If EU member countries determine that privacy protections in the United States do not meet their standards for adequacy, the flow to the United States of personal data about EU citizens, including personal financial information, may be restricted. Such restriction could impair the ability of U.S. financial services entities to function fully in the global market. It is possible that the U.S. securities markets could be affected.